Office of Chief Counsel
Internal Revenue Service
memorandum

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RMBoulanger

date: SEP 2 7 1999

to: John Camp, Case Manager
[redacted]

from: District Counsel, Buffalo

subject: [redacted]/**Standby Fee** / [redacted]

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ISSUE

This memorandum is in response to your request for advice concerning the above-referenced matter. Specifically, the issue

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[1/]A copy of this opinion is being sent to the National Office for post-review and any guidance they may deem appropriate. We will inform you of any modification or suggestions, and if necessary we will send you a supplemental memorandum incorporating any such recommendation.

is whether [redacted] may deduct certain loan standby fees it incurred over the life of the contract period.

It is our position at this time based upon the explicit analogy of commitment fees to option premiums in Rev. Rul. 81-160, the commitment fees are deductible either over the term of the loan, if [redacted] draws the available funds, or when the applicable commitment period expires.

With respect to the methodology used, we agree that it appears inaccurate and may be inappropriate. As such, every effort should be made to accurately identify when the lines of credit expire and when [redacted] no longer contracts with that particular bank. The proposed adjustments should also be modified to include the credit lines that did expire to the extent [redacted] verifies the amount of commitment fees expended for the years at issue.

FACTS & BACKGROUND

You are requesting our opinion as to whether to continue to support an unagreed issue at [redacted] for the [redacted] through [redacted] tax years. This adjustment was originally proposed by the [redacted] exam team. The issue concerns the timing of deductions for certain "standby fee"s paid by [redacted] upon entering into contracts with various banks to acquire unsecured lines of credit.

The issue for the [redacted] through [redacted] tax years is presently in Appeals. The adjustment proposed by the prior cycle is premised upon allowing the deduction at the time the right to borrow expires. The taxpayer has deducted these fees over the life of the contract period. Further, in the event that we believe the examining agent's position is correct, you wish to know whether the methodology used to "set up" the adjustment is proper.

Each year the taxpayer enters into [redacted] to [redacted] individual contracts which extend for periods of [redacted], [redacted] [redacted] or [redacted] years. The contracts state that funds will be available up to a stated amount at the prime rate or any rate mutually agreed upon by the bank and [redacted]. The fee charged by the banks is charged in arrears quarterly on the available amount of credit on the date after the end of the quarter to which it pertains.

For example, during [redacted], the commitment fees ranged from [redacted] basis points (.[redacted]%) to [redacted] basis point (.[redacted]%) per annum times the amount of the credit facility. The commitment fees were paid quarterly in arrears. If [redacted] s line of credit with a lender for the period from [redacted] were $[redacted] and the commitment fee were [redacted] basis points, the commitment fee paid to that lender for the first quarter of [redacted] would be $[redacted] ([redacted] of [redacted]% of $[redacted] multiplied by [redacted] and it would be paid at the end of the first quarter ([redacted]).

The ability to borrow covered by that payment would end at the end of the quarter. [redacted] would need to pay again if the standby commitment continued for another quarter. Since [redacted] needed to continue to pay for the commitment and it could cancel on [redacted] days notice, it actually had a series of [redacted] commitments that could be stopped at any time.

Further, the credit agreements did not permit [redacted] to borrow at a fixed interest rate. Instead, they only permitted [redacted] to borrow at the prevailing market rate of interest (such as a rate based on LIBOR). Thus, the credit agreement did not "lock in" a fixed interest rate.

[redacted] may terminate the agreement on [redacted] days notice to the bank. [redacted] contends that it had no plans to use the lines of credit at the time it entered into the contracts except in the event of a possible but unknown contingency. They have in fact never used them.

The purpose of this arrangement is apparently to bolster [redacted]'s credit rating. This in turn permits [redacted]s actual borrowing to be at a reduced rate of interest. Since the standby fees were incurred to reduce current interest expense, [redacted] deducted the fees at the time of payment.

In the prior cycle, Examination proposed a two-step method which (1) disallowed in full all deductions related to the lines of credit in [redacted], [redacted] and [redacted] and (2) allowed as a deduction [redacted] of each of the adjusted amounts over the subsequent [redacted] years.

	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Fees Disallowed	$[redacted]	$[redacted]	$[redacted]		
[redacted] Fees		[redacted]	[redacted]		
[redacted] Fees			[redacted]	$[redacted]	
[redacted] Fees				[redacted]	$[redacted]

This methodology was apparently employed by the previous Examination cycle to simplify the computations which would have been necessary if [redacted] or more individual contracts were each separately addressed. It is your opinion that this is a very inaccurate solution for several reasons which you list below.

For instance, consider that the $[redacted] in fees for [redacted] is comprised of contracts which vary from [redacted] to [redacted] years and that each contract would be at a different point within its time span. The $[redacted] does not represent the amount paid for contracts entered into in [redacted] but is the sum of the taxpayer's quarterly payments on their ongoing contracts. Some portion of the $[redacted] must represent payments made at the conclusion of contracts, which would then be deductible according to the theory which justifies the proposed adjustment. Yet, the entire amount of the payments is disallowed in [redacted] through [redacted].

The method allowing the deduction ([redacted] percent in each of the [redacted] subsequent years) is also imprecise given that the contracts range from [redacted] to [redacted] years and the quarterly payment may be for any point in time within the contract period. Implicit within the proposed methodology is an assumption that each contract is for a calendar year, and this is also untrue.

LAW AND ARGUMENT

Internal Revenue Code § 162(a) allows for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business."

Internal Revenue Code § 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Furthermore, Treas. Reg. § 1.461-(a)(2) states that "any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred."

From the standpoint of commitment fee payments made by borrowers, the Service has considered the timing of commitment fee deductions in Rev. Rul. 81-160, 1981-1 C.B. 312. In that ruling, the Service concluded that borrowers (in our case this would be [redacted] could not deduct the commitment fees when paid.

Specifically, Revenue Ruling 81-160 reconsidered the fact situation in Rev. Rul. 56-136, 1956-1 C.B. 92. Both rulings involved commitment fees incurred pursuant to a bona-fide sale agreement under which funds for construction were made available in stated amounts over a specified period. Rev. Rul. 56-136 concluded that the commitment fee was not interest and that the fee was deductible under I.R.C. § 162. Rev. Rul. 81-160 revoked Rev. Rul. 56-136 with respect to the deductibility of the commitment fee, and in doing so characterized the fee not as an interest charge, or a service charge, but a charge for the acquisition of a property right. The ruling states:

> A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. See Rev. Rul. 75-172, 1975-1 C.B. 145, and Francis v. Commissioner, T.C.M. 1977-170. If the right is not exercised, the taxpayer may be entitled to a loss deduction under I.R.C. § 165 when the right expires. See Rev. Rul. 71-191, 1971-1 C.B. 77.

Rev. Rul. 81-160, Supra, at 313.

Thus, based on its explicit analogy of commitment fees to option premiums, the Service held that commitment fees are deductible either over the term of the loan (if the borrower draws the available funds) or when the commitment period expires (if, and presumably to the extent that, the borrower does not draw on the available funds). Although the Service reversed its prior holding in Rev. Rul. 56-136, it does not appear that the Service also abandoned the characterization of commitment fees contained in Rev. Rul. 56-136.

In comparing commitment fees to option premiums, the Service's characterization of commitment fees as "the acquisition of the right to the use of money" would appear to be in harmony with the Service's earlier description of commitment fees in Rev. Rul. 74-258 (regarding "loan funding" fee income of REITs) as "paid or incurred in consideration of the lender's commitment to lend construction funds rather than in consideration of the borrower's use of the funds."

Rev. Rul. 81-160 may be construed as consistent with Rev. Rul 56-136, at least to the extent of its characterization of commitment fees as option premiums. Rev. Rul. 81-160 may be viewed as somewhat of a technical correction of the Service's position in Rev. Rul. 56-136 to bring the treatment of commitment fees into line with the treatment of option premiums under other revenue rulings. (See, Rev. Rul. 58-234, 1958-1 C.B. 279 and Rev. Rul. 78-182, 78-1 C.B. 265.)

In the case at hand, the taxpayer has acquired numerous property rights similar to the costs of options. Since the taxpayer did not exercise the right because they did not use any of the lines of credit, they were entitled to a loss deduction under Section 165 when the right to borrow expired.

The fee here, like the loan commitment fees in Rev. Rul. 81-160, is a fee for the availability of money. As such it is a fee charged for the acquisition of a property right, the right to the use of money, and not for the performance of services.

The commercial paper issued by [redacted] is maintained on a long-term basis with ongoing credit availability provided by unused, revolving bank lines of credit. The contract agreements with the banks are revised yearly to equal the amount of the commercial paper outstanding. The lines of credit are in substance extended indefinitely.

Thus, based upon Rev. Rul. 81-160, the right to borrow expires when the taxpayer no longer contracts with a particular bank.

The taxpayer has filed a Protest with Appeals for the [redacted] through [redacted] tax years. Since the issue is the same for the [redacted] through [redacted] tax years analyzed here, we assume the taxpayer's argument will be somewhat consistent.

In the Protest filed for the [redacted] through [redacted] tax years, the taxpayer relies upon Letter Ruling 8138092 in support of its argument that the commitments are deductible in the year paid. However, it is well settled that although these written determinations are made public, taxpayers may not rely upon them as precedent. I.R.C. § 6110(j)(3).

In any event, although the taxpayer's arguments are more fully set forth in the attached Protest, it appears that one of the main arguments is that it never intended "to draw on its commitment agreement and in fact never did so." (See Protest pgs. 22-25).

It is our position that the taxpayer's reliance on an intention not to draw on the commitments is misplaced. We believe what is critical is that the taxpayer had the opportunity, if need be, to draw on the commitments.

With respect to the methodology previously employed by Examination, we agree that they appear to be inaccurate for the reasons discussed briefly above. Although we support the disallowance of these fees over the life of the contract period, we belief every effort should be made to accurately identify when the particular lines of credit expired and when [redacted] no longer contracted with the particular bank.

If you have any questions regarding this matter, please contact Ray Boulanger at (716) 551-5610.

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